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ABSTRACT

This booklet, intended for trustees of institutions of higher education, offers some instruction on the principles of risk management. Introductory information provides a definition of risk management, which is seen as a planning and strategic function, not solely as a financial or safety assessment. Individual sections then address the following topics: (1) an institution's critical areas of risk exposure (noting four levels of governing board involvement); (2) the realities of risk (noting traditional operational risk, legal and regulatory risk, financial risk, and political and reputational risks); (3) basic methods of risk management (avoidance, control, transfer, acceptance); (4) organizational structures for risk management; (5) risk management tools; (6) the board's role; and (7) the cost of risk management. Each section also provides questions to consider in applying principles to a specific institution. A suggested format for a management report to trustees concerning institutional risk management is also provided. (DB)

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BOARD BASICS

STRATEGIC DECISIONS

ESSENTIALS OF RISK MANAGEMENT

BY BURTON SONENSTEIN AND
LAURA A. KUMIN

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ESSENTIALS OF RISK MANAGEMENT

Colleges and universities have experienced an incredible array of events that have led to serious losses: financial mismanagement; misuse of federal funds that have led to fines and sanctions by regulatory agencies; speculative investment scams involving rogue traders; sexual harassment involving tenured faculty; loss of accreditation; tragic deaths and injuries resulting from campus crime, crowd panic, alcohol abuse, hazing, and hazardous substances; and devastation from earthquakes, hurricanes, fire, tornadoes, and floods. Although it may be impossible to foresee a particular event, effective risk management often can mitigate the loss.

Information technology is another strategic risk exposure as computers and other equipment grow obsolescent. The "wired" campus and integration of e-mail, the Internet, and document retrieval create significant vulnerability for the learning and administrative functions of colleges and universities. If your institution were to lose electrical power or computing capabilities for several hours or days, how long could it function? Do emergency back-up arrangements contemplate recovery from a direct hit by a natural disaster?

Trustees and administrators must treat disasters as inevitable. The key is to anticipate and respond rationally to the most serious exposures that could compromise the ability of the enterprise to function.

Trustees have legal and fiduciary responsibilities to protect their institutions, and they are exposed to potential personal liability if they do not exercise sufficient oversight of institutional affairs. Guarding the institution against harm requires management systems, not just ad-hoc responses. Boards should insist that senior administrators devise a

comprehensive plan that maps out risk scenarios and potential responses. A comprehensive program of risk-management policies and practices not only enables trustees to discharge their duty of care but also goes a long way toward preventing or mitigating serious risk and loss to their institutions.

What is risk management from the trustee's perspective? Just as good financial management is more than a clean audit opinion, good risk management is more than an insurance program. Trustees should insist that risk management is defined more broadly than insurance and loss control. Felix Kloman, formerly a Tillinghast Towers Perrin managing director, has created such a definition:

"Risk management is a discipline for living with the possibility that future events may cause adverse effects. Risk won't disappear. It cannot be legislated out of existence. Technology can't make it vanish.....and insurance doesn't really transfer it; it only apports some of its costs through an imperfect funding mechanism.... Risk management should be seen more as a 'function' than a specific position. It should be practiced by many levels of management with coordination and guidance from a senior level. Risk management becomes a planning and strategic function, not solely a financial or safety assessment."

AN INSTITUTION'S CRITICAL AREAS OF RISK EXPOSURE. Governing boards should ensure that strategic plans and operating policies and practices adequately address critical risk exposures in every area of activity. Specifically, governing boards should be involved in risk management at four levels:

- ensuring that risk management is an institutional priority,
- calling on senior administrators to devise a risk-management mission statement,
- ensuring that the administration puts that statement into practice through appropriate policies and procedures and formal assignment of responsibility for risk assessment and management, and

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- monitoring the plan's implementation through regular, formal reporting to the appropriate board committee by the appropriate senior administrator. This official should be held accountable for reporting risk identification, assessment, and evaluation, as well as resource allocation and outcomes.

Questions to Consider

- Has the board ever discussed its responsibility for risk management?
 - Does your institution have a policy statement regarding risk management? If so, does the statement address institutional expectations for loss control, loss avoidance, risk transfer, and retention of risk?
-
- Does the board or a board committee regularly receive a risk-management report?
 - As part of strategic planning, does the board consider major risks to the successful operation of the institution and appropriate strategic responses?
 - Does the board or a board committee periodically review open and closed litigation, trends in litigation costs and outcomes, and measures to prevent or ameliorate future litigation?
 - Does the board or a board committee review comparative information regarding insurance coverage, the cost of risk, self-insured retentions, loss control, and disaster-recovery plans and training?
 - Does the institution conduct periodic independent reviews of legal and regulatory compliance, loss control, and loss engineering audits? Does the board review results in a manner similar to the auditor's reports of internal financial controls?

THE REALITIES OF RISK. The complexity and potential consequences of risk for higher education institutions have escalated in the last two decades. For example, employment-related complaints and lawsuits have gone from a relatively rare misfortune to an everyday occurrence. A mind-boggling assortment of laws and court decisions now govern the employment relationships between an institution and its faculty and staff. The potential consequences of a class-action employment suit, a government investigation, a whistle-blower's suit, or an antitrust or consumer-law claim can be staggering to an institution's reputation and its pocketbook.

Although traditional negligence suits and property losses from natural disasters continue to present risk, such exposures represent only a small part of the institution's total risk "profile." Increasingly, sophisticated businesses and nonprofit organizations define their exposures in broader terms and focus on risk management as a crucial means to accomplish the organization's mission.

Institutions typically are exposed to four types of risk.

- **Traditional operational risk** includes a weather catastrophe or a fire that severely affects teaching or research for an extended period, makes significant facilities unusable, or shuts down the campus. Less obvious but equally important are the operational risks of a strike or civil unrest on campus, crime-related crises such as sniper and hostage situations, and the dangers of an explosion in a power plant or a chemical spill in a laboratory.

Machinery breakdowns, whether a boiler or a sophisticated computer system, also pose serious operational risks. Moreover, when computer systems fail, computer-dependent campuses may be vulnerable to related exposures in security and fire-safety systems, elevators, and sophisticated life-support equipment. A single operational problem, such as a power outage, can have a devastating effect across campus. Trustees should make sure crisis-management and disaster-recovery plans exist. Have they been tested? Are they accessible when the crisis occurs?

- **Legal and regulatory risk** includes litigation by employees or students claiming discrimination or failure to comply with environmental or safety requirements, and it may be the fastest growing area of exposure. Claims often include allegations of discrimination, ranging from sexual harassment to failure to accommodate a learning or physical disability.

Increasingly, processes such as tenure evaluations and student disciplinary actions generate acrimonious, lengthy, and expensive litigation. Regulatory exposures include gender equity in athletics, whistle-blower investigations, federal and state employment-discrimination investigations, and local oversight of land use.

- **Financial risk** includes such events as a sudden drop in tuition revenue or enrollment, an investment loss caused by imprudent trading, a decline in government appropriations in support of student financial aid or faculty research, or a fund-raising campaign that did not meet expected levels. Officials also may find that funds are not being used for intended purposes or that investment decisions are not following specified criteria regarding quality and risk.

- **Political and reputational risks** include the loss of accreditation, the imposition of NCAA sanctions, or an adverse public response to a high-profile crime on campus. Each can undermine the support of key constituents and may significantly affect an institution's long-term prospects.

Perhaps the most serious risk to an institution's academic reputation is the threatened or actual loss of accreditation, which can affect enrollments and institutional prestige for years. A major institutional scandal—whether it involves NCAA sanctions, misbehavior by senior officials, scientific misconduct, governmental fines and sanctions, or class-action litigation—almost always carries the risk of severe damage to the institution's reputation. For public institutions, a major confrontation or dispute with legislators can create a serious loss of public support and may lead to a fiscal crisis. Moreover, legislative initiatives can change the governance structure of a public institution or its relationship to other parts of government.

Questions to Consider

- Has the institution evaluated its risk in all areas? Is that evaluation in a written report?
- What are the current high-priority exposure areas? What goals have been identified for each area to reduce, transfer, or mitigate risk? Should risk objectives or tolerances be specified to guide actions in each area?

- | | |
|---|---|
| <ul style="list-style-type: none"> • Does a campus crisis-management or emergency-response plan exist? When was it last tested? Is it readily accessible to those who need it? What events or occurrences might trigger it? How strong is the collaboration and communication with public-safety and emergency agencies? | <hr/> <p>FOR KEY AREAS OF
EXPOSURE, INSTITUTIONS
SHOULD NOT SEEK TO</p> |
| <ul style="list-style-type: none"> • Does the board have the formal responsibility to periodically review areas of major risk exposure and assess the adequacy of risk-management plans? | <p>ELIMINATE RISK
(A VIRTUALLY IMPOSSIBLE
GOAL) BUT TO MAINTAIN</p> |
| <ul style="list-style-type: none"> • Does the institution employ an administrator with designated risk-management and insurance responsibilities? Does the institution periodically have an objective outside review or audit to determine those aspects of risk management that may be improved, whether insurance coverage is adequate, which functions might be self-insured, whether officials need to improve safety practices, and so forth? | <p>A "BALANCED
PORTFOLIO" OF RISK.</p> <hr/> |
| <ul style="list-style-type: none"> • Does the institution have a written investment policy statement and endowment spending policy? Does the board periodically review and approve such policy statements? | |
| <ul style="list-style-type: none"> • Does the institution have written policies and disclosure requirements covering conflicts of interest and business dealings with donors, alumni, and trustees? | |
| <ul style="list-style-type: none"> • Does the institution have public-relations and media-relations plans to respond to serious losses or a potentially scandalous or embarrassing situation? | |

UNDERSTANDING RISK MANAGEMENT. Traditionally, loss control has focused on safety, physical injury from slips and falls, and property damage from natural disasters; risk management has been synonymous with the purchase of insurance. Now, however, the risk-management process incorporates identifying and evaluating all types of risk and analyzing whether various risks should be avoided, controlled, transferred, or accepted. To identify risks in this context, trustees need a comprehensive understanding of the institution's academic, research, and support activities. To analyze those risks thoroughly, they must possess a clear sense of the institution's mission and priorities.

An effective risk-management process yields practices that reasonably balance risk exposures, protection, and prevention strategies with institutional priorities and resources. For example, if officials are considering whether to invest in campus fire-safety features that exceed codes, they must balance the costs involved against other funding needs and priorities. Institutional leaders must decide if the institution can achieve an acceptable level of protection instead through periodic inspections for fire hazards and other measures.

For key areas of exposure, institutions should not seek to eliminate risk (a virtually impossible goal) but to maintain a "balanced portfolio" of risk. Trustees should participate in decisions regarding the institution's overall tolerance for risk and the distribution of risk in operations, finances, and regulatory and legal compliance. With respect to the purchase of insurance, for example, the board should be comfortable that the level of deductibles and self-insurance are appropriate. These should not be so high that the institution is left vulnerable if it experiences an unusually large number of claims. Conversely, trustees should question a pattern of low deductibles if the pattern translates into high insurance premiums that conceivably could be avoided by self-insurance and pooling mechanisms.

Institutional leaders typically employ four basic methods of handling risk, most often using a combination of two or more strategies to handle a single risk.

- **Avoidance** involves changing the institution's activities or restricting the scope of risk-prone behavior to diminish the likelihood or severity of risk. For example, if an institution chooses to terminate an academic program, the strategy may include avoidance—phasing out the program gradually to lessen the impact on affected students and faculty.
- **Control**—instituting good policies, practices, and procedures—might be used in conjunction with an avoidance strategy. For example, when terminating a program, control measures might include a communications program that explains a potentially high-risk situation to alumni, department faculty, and the community.
- **Transfer** limits the financial consequences of risk through the purchase of insurance or third-party indemnification or covers the risk of suits by students and employees adversely affected by changes.
- **Acceptance** strategies indicate that institutional leaders accept the risk inherent in a specific activity and recognize that it cannot be avoided, transferred, or controlled if the institution is to accomplish its mission.

Risks change and so will an institution's risk profile. For example, if an institution establishes links with a corporation interested in the work of its engineering or medical research faculty, the institution should examine how these links change its risk profile and whether its existing risk-management methods continue to be appropriate.

Other changes, such as new regulations from the U.S. Department of Education or laws such as the Americans with Disabilities Act (ADA), affect how organizations treat many kinds of individuals. For example, before ADA became effective in the early 1990s, disability claims by college and university employees were relatively rare, and institutions generally did not devote considerable resources to managing those claims. Now, however, about 15 percent of all the discrimination claims filed by employees of academic institutions allege disability discrimination. Obviously, the need for training and claims management in this area is more pressing than before the ADA was enacted.

Predicting when or how often potential risk will turn into actual loss and anticipating the severity of a loss is an inexact science. This is true whether the risk involves natural disasters or employee lawsuits. In assessing the chances of significant litigation and the likely outcome and cost of defending a suit, officials can research an institution's history of grievances, EEOC complaints, and similar data.

To stem the frequency and severity of claims involving layoffs or tenure denials, trustees and others must examine the underlying situations—the tenure-review process and the personnel implications of budget problems. With employment claims often costing more than \$100,000 per lawsuit, every institution should have effective internal processes and procedures for resolving employment disputes. Senior administrators should understand these processes and procedures and be prepared to defend the institution in the event of a claim.

However, trustees and administrators may not be able to predict or measure certain risks, especially those that arise from emerging conditions, such as new uses of technologies and new partnership ventures. Nevertheless, they must strive to assess the institution's tolerance for the potential losses or litigation that may arise from such exposures. They may express the institution's risk tolerance in rough ranges: "We are unwilling to tolerate more than a 50-50 probability of a loss of more than \$100,000 in a given year." Or: "We are unwilling to tolerate more than a 10 percent chance of a loss of more than \$250,000 if we can buy insurance to cover that loss for \$5,000 or less."

ORGANIZATIONAL STRUCTURES FOR RISK MANAGEMENT. The management structures for dealing with risk vary; no specific structure is ideal for every institution. Examples of typical structures include the following:

- a designated risk manager or risk-management department;
- a chief financial officer who handles risk management either alone or with legal counsel;
- a finance or purchasing administrator who has insurance responsibilities, including purchasing and safety and loss control; and
- a combination of in-house administrators and risk-management consultants.

Generally, only large, comprehensive universities are able to employ full-time risk managers, although small institutions can obtain the expertise of a risk manager through consortia and insurance-buying pools. While coordination and structure are important elements of an effective risk-management structure, they are not substitutes for individual responsibility. All managers—from administrative supervisors to faculty deans—should be held accountable for managing risks within their areas,

particularly those activities in their direct control (safety, personnel relations, compliance). It is helpful to remind managers of these responsibilities through explicit references in job descriptions and to reinforce "risk vigilance" through periodic training on risk evaluation and management.

RISK-MANAGEMENT TOOLS. As risks have grown increasingly numerous and complex, so have the tools and techniques to manage them. Electronic communication makes it possible for institutions to establish online manuals for policies and procedures on topics ranging from vehicle safety to foreign-study programs to technology transfer. New training systems can be accessible to every student and employee with a computer through networks, the Internet, or CD-ROM technology, and numerous publications address risk-management issues in education and in specific exposure areas. The University Risk Management and Insurance Association (URMIA) publishes a journal and has a listserv through which campus risk managers share ideas and provide assistance to one another. Risk-management audit programs and questionnaires on virtually every educational risk exposure are available from brokers, insurers, and United Educators Insurance Risk-Retention Group.

For these tools to be effective, the board and senior administrators must articulate their support of and commitment to a serious risk-management program. With such support, an administrative risk-management or safety committee can identify needs and priorities, institutionalize improved practices, conduct regular training, and monitor experiences and trends.

Questions to Consider

- How frequently does the institution review major areas of risk exposure? Do such reviews consider scope of risk, insurance coverage, loss experience, loss-control activities, and training for each risk?
- What major exposure areas have been identified? Does the institution conduct training on risk-management topics to raise awareness and motivate behavior that complies with civil-rights laws? What level of investment does the institution make in training, and how does this compare with the potential costs of litigation?

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- What senior managers are responsible for risk analysis and management? Is the responsibility assigned at a sufficiently high level?
- For risks that require crisis management or contingency plans, have officials created and disseminated appropriate plans and practiced them?

THE BOARD'S ROLE. A board can best monitor and oversee risk management through its committee structure. There is no definitive rule as to which committee should be responsible. Generally, strategic risks are best evaluated in a long-range planning

or finance committee. Operational exposures and the measures to manage them often are best addressed by the audit committee. Investment-policy risks often are managed by the investment committee, although the full board or the audit committee periodically should review investment policies. In large universities with medical centers and significant self-insurance and captive-insurance operations, a risk-management committee may be advisable.

Board guidance will keep the institution focused on risk management as an important discipline, encourage attention to risk-management processes through monitoring, and give trustees with professional or other special experience an opportunity to offer input that may alert institutions to various risks or issues.

The board's scrutiny of risk-transfer mechanisms, such as insurance, should focus on the following matters:

- whether management adequately has considered self-insurance and alternative risk-transfer options such as captives and risk-retention groups and pools;

- whether management has fully analyzed the insurance providers it has chosen, including their financial strength, stability, services, and history of providing coverage when claims are made (A.M. Best and other ratings agencies annually evaluate and rate insurance carriers); and
- whether self-insurance programs are adequately funded by reserves based on actuarial estimations of probable losses.

REPORTING AND MONITORING.

The best way for trustees to gain an overview of the health and effectiveness of risk management is to receive an annual risk-management report from the administration. The report can summarize the activity of the past year and provide pertinent multiyear trend data. The report should cover insurance coverage, self-insured or uninsured exposures, significant claims and losses, risk-management and loss-control initiatives, and special issues.

An outline of such an annual report appears on page 15. On more specific matters, the board can request reports of risk self-assessments conducted by the institution's administration, supplemented by external audits of selected areas. The board should conduct regular, rotating reviews of major areas of exposure to ensure the institution's approach is sound and policies and procedures actually are followed. Failure to follow institutional policies is one of the most damaging and costly findings in liability cases. Trustees should be satisfied that senior administrators regularly use risk assessments and audits to evaluate actual practices and that the recommendations and findings of external audits are addressed. In doing so, trustees will discover that risk-management responsibilities are strikingly similar to those regarding financial audits and management-control evaluations.

THE BEST WAY FOR
TRUSTEES TO GAIN AN
OVERVIEW OF THE HEALTH
AND EFFECTIVENESS OF
RISK MANAGEMENT IS
TO RECEIVE AN ANNUAL
RISK-MANAGEMENT
REPORT FROM
THE ADMINISTRATION.

Questions to Consider

- Is risk management assigned to appropriate board committees?
- What is the nature of administrative accountability to the board?
- How often does the administration review major risk-exposure areas?
- Has the board issued policies on risk in such areas as self-insurance and deductibles, investments, safety, regulatory compliance, and so forth?
- Has the board called on trustees and alumni who are experienced in insurance, risk management, litigation management, and dispute resolution?
- Would the board increase its awareness of the institution's overall risk profile by conducting a comprehensive, strategic risk assessment?
- Is the board aware of the range of risk exposure in each major strategic area, the likely cost of loss, and the measures taken or available to improve the avoidance or mitigation of loss?

THE COST OF RISK MANAGEMENT. Risk can be evaluated and managed at minimal cost if the institution devotes managerial attention and resources to these efforts, using senior officials to conduct assessments and compile a risk profile. If officials determine outside assistance is required, they will need to be certain they understand the scope of the project and can contain costs. Institutions are well advised to consult with counsel in structuring the review to maintain audit confidentiality, to the extent confidentiality is appropriate and feasible.

Trustees should be mindful of an important caveat: The commitment to evaluate risk exposure presumes a similar commitment to strengthen response to risk if current measures are found to be weak. The return on investment in improved safety and management practices can be high, given the cost of loss and litigation. Indeed, many insurance carriers will provide underwriting credits for institutions that undertake assessments and implement improvements.

The costs of responding to risk may seem considerable, but they pale compared with the high cost of failing to manage risk and consequently dealing with lawsuits, damaged reputations, and lost time and resources.

For example, when a student is seriously injured on campus, implementing a well-conceived crisis-response plan often can make the difference between a modest settlement to cover medical costs and expensive litigation.

Risk management pays dividends in employment-liability situations as well. The time and effort required to craft and implement a sexual-harassment policy and training program may be considerable, but those measures are crucial in protecting institutions when harassment claims are filed. In two 1998 decisions, the U.S. Supreme Court sent a strong message that employers seeking to avoid liability for supervisors' sexual harassment of subordinates must show they "exercised reasonable care to prevent and correct promptly any sexually harassing behavior."

No matter which type of risk is involved, the essence of true risk management is timely, effective action that follows a well-conceived plan or policy. Trustees who act on these principles fulfill their basic responsibilities to provide strategic direction and encourage good management practices at their institutions.

RESOURCES

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SUGGESTED MANAGEMENT REPORT TO TRUSTEES CONCERNING INSTITUTIONAL RISK MANAGEMENT

The format, content, and frequency of risk-management reports to the board and to senior administrators will vary according to the size and complexity of the institution. However, such reports generally should cover the following topics to ensure the board has sufficient information to assess the adequacy of risk management and insurance coverage.

1. Summary of Insurance Coverages
 - description of each type of coverage
 - limits of coverage and aggregates
 - deductibles and sublimits
 - premium (annual and five-year trend)
 - losses (paid and reserved) and loss ratio
2. Summary of Self-Insured and Uninsured Exposures
 - description of self-insurance mechanisms
 - actuarial analyses
 - payments of self-insurance reserves
 - major uninsured exposures (weather catastrophe, pollution, and fine arts)
3. Description of Significant Claims and Losses
 - damages
 - legal costs
 - insured versus uninsured costs
 - preventative strategies
4. Risk-Management and Loss-Control Initiatives
 - policies and practices
 - training provided
 - surveys, audits, and inspections
 - investments
5. Special Issues
 - regulatory or legislative compliance
 - opportunities to reduce overall cost of risk
 - program reviews
 - benchmark and survey analyses
 - significant changes in exposure

BOARD BASICS

This publication is part of **Board Basics**, an AGB series devoted to strengthening the effectiveness of governing boards and trustees.

Board Basics comprises several topic clusters—The Fundamentals, Financial Matters, Fund-Raising, Academic Affairs, Leadership, Strategic Decisions, and Effective Committees—each of which contains several booklets. Several assumptions underlie the series:

- Academic trusteeship grows increasingly ambiguous, and trustees need concise, accessible, and focused information to help them carry out their complex fiduciary and stewardship responsibilities.
- Basic principles of trusteeship remain constant across higher education, regardless of institutional type, size, and mission. The series highlights these general principles to provide trustees with a core of knowledge they can apply to their individual institutions.
- The series addresses the distinguishing characteristics of academic trusteeship, especially as it differs in scope, substance, and focus from corporate directorships and other board service.

AGB and the authors welcome comments and suggestions to improve this publication and others in the series. Call AGB publications at 800/356-6317 or visit our Web site at <http://www.agb.org> for more information.



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